INDEX

CITATIONS

In the Supreme Court of the United States

October Term, 1942

No. 766

Virginian Hotel Corporation of Lynchburg, petitioner

v.

Guy T. Helvering, Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 34–38) is unreported. The opinion of the Circuit Court of Appeals (R. 45–52) is reported in 132 F. (2d) 909.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 2, 1943 (R. 53). The petition for a writ of certiorari was filed February 25, 1943, and was granted April 5, 1943. The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

In its returns for the years 1931–1936 petitioner took deductions for depreciation which were not challenged by the Commissioner of Internal Revenue but are now found to have exceeded the amounts properly allowable. The deductions did not offset taxable income. The question is whether, in determining the adjusted basis of the property for the purpose of computing depreciation for the year 1938 under Sections 23, 113, and 114 of the Revenue Act of 1938, the cost basis should be reduced by all the excessive deductions taken in the earlier years, or only by the amount which offset gross income. The answer depends upon whether these deductions were "allowed" within the meaning of Section 113 (b) (1) (B) of the Act.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
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> (l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *
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(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

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SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) * * * The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis pro-

vided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 113 (b)–1. *Adjusted basis: General rule.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, is the cost of such property or, in the case of such property as is described in paragraphs (1) to (18), inclusive, of section 113 (a), the basis therein provided, adjusted to the extent provided in section 113 (b).
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> The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *
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> The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect of any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under the Revenue Act of 1938 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto,

> whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. * * *
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> * * * * *

The other applicable regulations are Articles 23 (l)-1, 23 (l)-2, 23 (l)-4, 23 (l)-5, 23 (l)-9, and 114-1 of Treasury Regulations 101.

STATEMENT

The following facts were stipulated (R. 9-17, 22-33) and found by the Board of Tax Appeals (R. 34-38):

Petitioner, a Virginia corporation, was incorporated in 1930 as successor to a partnership which had operated a hotel in Lynchburg, Virginia, since June 1, 1927. Petitioner continued these operations. (R. 34.) Each year from June 1, 1927, through 1937, depreciation was taken without objection at straight line rates of 10 percent on all of its equipment except carpets and upon these of 15 percent, based upon an estimated useful life of 10 and 6⅔ years, respectively (R. 25, 37). For

the year 1938 petitioner claimed a deduction for depreciation at the same rates, but the Commissioner determined that the useful life of the equipment had been underestimated and that the rates of depreciation allowed were excessive. The useful life of the equipment, except carpets, was estimated at 20 years and carpets at 12½ years, resulting in depreciation rates of 5 percent and 8 percent, respectively. In the computation of the deficiency, the depreciation theretofore claimed as a deduction was subtracted from the cost of the property, and the remainder was taken as the new basis for computing depreciation. As a result, the Commissioner disallowed $3,046.50 of the amount of depreciation claimed by the taxpayer in its return, thus allowing a deduction in the amount of $1,295.47. (R. 10-12, 15-17, 25, 37.)

The partnership had had a net gain for each of the years from June 1, 1927, to December 31, 1930, and petitioner had a net gain in 1937. The deductions taken for depreciation in those years served to reduce taxable income. Petitioner sustained a net loss for each of the years 1931 to 1936, however, and the excessive depreciation deducted in its returns for those years did not serve to reduce its taxable income. (R. 25, 37.)

In the proceedings before the Board of Tax Appeals, petitioner did not question the new rates. Its contention was that the depreciation claimed for the years 1931 through 1936 in excess of the amount properly allowable, which did not serve to

reduce taxable income in those years, should not be subtracted from the depreciation basis. (R. 38.) The Board of Tax Appeals sustained petitioner (R. 38), but the court below reversed (R. 52).

SUMMARY OF ARGUMENT

Section 113 (b) (1) (B) of the Revenue Act provides that the basis for computing depreciation shall be adjusted for prior depreciation "allowed (but not less than the amount allowable)." Because it now appears that petitioner took excessive deductions for depreciation, the issue here is whether the word "allowed" refers simply to deductions taken on petitioner's return and not disallowed by the Commissioner, or requires also that the deduction reduce petitioner's tax. Petitioner claims the latter meaning must be adopted to avoid hardship. The hardship which petitioner finds in the Commissioner's contrary position is nonexistent: if any hardship resulted it would flow from petitioner's own voluntary act of deducting more than allowable amounts for depreciation and would have been present even if the Commissioner had permitted petitioner to continue to deduct the excessive amounts of its own choosing. Moreover, petitioner's position would actually place those deducting excessive depreciation in a more favorable position for some purposes than other taxpayers, a tax subsidy which surely Congress did not intend.

The tax benefit theory does not inhere in the word "allow" any more than it does in the companion

word "allowable." Moreover, the legislative history from which petitioner draws a Congressional purpose to limit "allowed" by a tax benefit qualification not only does not support petitioner but actually shows a purpose which petitioner's construction would flaunt. Finally, the 1942 legislation, which provides that recoveries of bad debts and taxes shall be included in taxable income only if prior deductions had resulted in a tax reduction, recognizes that, in the absence of such specific provision, there is no tax benefit theory in the income tax laws. The legislation writes the requirement into the statutes only for certain carefully defined items, of which excessive depreciation is not one. Judicial adoption of the rule in this situation would result in inconsistencies with the application of the statutory amendments.

ARGUMENT

THE COURT BELOW CORRECTLY HELD THAT THE TAXPAYER'S BASIS FOR DEPRECIATION SHOULD BE ADJUSTED BY THE ENTIRE AMOUNT OF DEPRECIATION CLAIMED FOR PRIOR YEARS.

Section 114 (a) of the Revenue Act of 1938, *supra,* provides that the basis for depreciation shall be the adjusted basis provided in Section 113 (b), *supra,* for the purpose of determining the gain upon sale or other disposition of the property. Section 113 (b) (1) (B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913, for depreciation, "to the extent allowed

(but not less than the amount allowable)" under the Act or prior income tax laws.

The instant case turns on the meaning of the word "allowed." We submit that the court below correctly held that depreciation is "allowed" within the meaning of the statute, where it is claimed by the taxpayer and not disallowed by the Commissioner. The petitioner's contention is that the deduction must also offset net income. But we find nothing in the statute, the regulations, the legislative history, or the relevant considerations of administrative practice, which supports the conclusion that a deduction can be treated as allowed only when it results in such a tax advantage to the taxpayer. On the contrary, the available evidence supports the interpretation adopted by the Government.

1. It is important at the outset to emphasize that the Government's position is both reasonable and consistent with the theory of the statute. It becomes evident, upon analysis, not merely that the taxpayer's claims of hardship are unwarranted, but that its construction of the statute would place a premium upon claims for excessive depreciation allowances.

The statutory allowances for depreciation provide a taxpayer an opportunity to recover tax-free his investment in property which is used in producing income and is being consumed or is

deteriorating in the process.[1] In taking the deductions, he is required to estimate in advance the anticipated life of the property and is required to spread the deductions over that estimated life. Thus, if he estimates that the property will have a useful life of 20 years, he will each year deduct from income 1/20 of the cost or other basis of the property; accordingly, over the 20 years he is deriving income from the property he will be permitted to take deductions equal to his investment in the property.

Based as it is on beforehand estimates of useful life, the method, of course, cannot be precise and adjustments will sometimes be necessary. Experience with the property will often show that the useful life of the property has been overestimated or underestimated. When this occurs, a new estimate is made, and the basis of the property, to the extent that it has not been recovered by prior deductions, is spread over the remaining life as thus reappraised.[2] This is accomplished

[1] Depletion is the name given to the process and method when wasting-asset properties, such as mines and wells, are involved. Though closely allied to depreciation, depletion is and always has been governed by different statutory provisions. Cf. *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 524–525. See I. R. C. Section 114 (b). The depletion allowance, to an even greater extent than the depreciation allowance, does not contemplate an exact recovery of investment.

[2] No adjustment is made for the depreciation deductions for the years preceding the reappraisal which are still open under the statute of limitations. *Sample-Durick Co.* v. *Commissioner*, 35 B. T. A. 1186.

under the statute involved here, by reducing the original basis by depreciation previously "allowed," or that "allowable," whichever amount is greater, and by applying to this adjusted basis the new rate calculated upon the new estimate of useful life. For example, if after 15 years it were determined that property, instead of having a 20-year life (with 5 years remaining), had a 25-year life (with 10 years remaining), the remaining unrecovered basis would be spread over 10 years instead of 5. As a consequence, the deduction for each year would be half as large as under the original computation, but the privilege of taking depreciation deductions would last twice as long.[3]

Such a change does not reduce or increase the total amount of depreciation the taxpayer will be permitted to deduct. The change merely increases the number of years over which the deduction will be spread. Thus in the case at bar, the Government's position will permit petitioner to deduct the same total sum for depreciation as if it had been permitted to continue deducting excessive amounts until the basis was exhausted. The only difference is that petitioner will now

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[3] This general method is not challenged by petitioner, and petitioner's own computation of the basis of its property accepts the Treasury position that "allowable" depreciation is that which could have been properly deducted, regardless of tax benefit. (R. 25–26.) Petitioner's contention herein is, however, that "allowed" depreciation is only that which was deducted to the tax benefit of the taxpayer.

deduct smaller amounts each year over a longer period. This will mean that petitioner's net income for the immediate years will be greater than if it still deducted excessive depreciation. But it will also mean that petitioner's net income will be less in subsequent years than otherwise because depreciation will still be available to offset gross income for those subsequent years; whereas if petitioner had gone on its way deducting excessive amounts now its basis would have been entirely exhausted in those subsequent years, in which the property will still produce income.

It is delusive, therefore, to speak of hardship or unfairness in this situation. It is impossible to tell whether or not the Government's position will cause petitioner in the long run to pay higher taxes than its own error uncorrected would have caused it to pay and no intelligent guess can be made. It may pay less. Any hardship resulting from the wasted depreciation deductions of past years would have been present even if the Commissioner had not prevented petitioner from continuing to take excessive deductions. That hardship is one of the taxpayer's own making in taking the excessive deductions—a point emphasized by the fact that the determination of the correct depreciation rate rests on facts peculiarly within petitioner's own knowledge and involves a judgment which in the first instance petitioner was best equipped to make. Cf. *Helvering* v. *Lerner Stores Co.,* 314 U. S. 463.

The taxpayer, however, would turn the rate reduction to its definite advantage. Except insofar as the statutes have specifically provided for loss carry-overs,[4] the revenue laws do not contemplate that a taxpayer shall be allowed to take advantage in a later year of deductions available in earlier years which gave it no tax benefit because of insufficiency of income. Each tax year stands on its own footing. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. Consistently with the depreciation schedule which had been employed since 1927, with the approval of the Commissioner, the taxpayer continued to take these deductions through its loss years 1931–1936. The deductions were actually available to it, just like any other deduction to which it was then entitled, although it was subsequently found that the amount had been excessive. Indeed, the taxpayer continued to use the same rate in the year 1937 when it had net income and admittedly derived a tax benefit from the excessive claim, which it could not have done if it had undertaken to reduce the rate. Ordinarily the taxpayer could not expect to recoup the deductions wasted in its bad years. What its position here means is that the necessity of having to reduce the rate in 1938 should serve as an occasion to permit it to recoup its wasted deductions. This would not

[4] For an outline of the history of the net loss carry-over provisions, see Mertens, *Law of Federal Income Taxation*, Sec. 29.01 *et seq.* See also Revenue Act of 1942, Sections 150 (e), 153, 204.

have been permitted if the rates had not been changed; there is no reason why this circumstance should serve as an excuse.

On the other hand, the petitioner's position is not only inconsistent with the basic principles underlying the theory of depreciation allowances, but also it would provide taxpayers an incentive to make their claims for depreciation excessive. The statutory method of allowing for depreciation contemplates annually recurring deductions. These deductions will afford the taxpayer the opportunities of (1) reducing each year's gross income from the property by an amount equal to the estimated depreciation in value for that year, and of (2) recovering his investment tax-free. But while each of these opportunities is afforded the taxpayer, neither is guaranteed him. If a taxpayer continues to use property in his business and to produce gross income with it after it has been fully depreciated, he will receive no further depreciation deductions with which to reduce his gross income. On the other hand, if the amount properly "allowable" as the annual depreciation deduction exceeds the gross income in one or more years, so that some of the properly allowable deduction does not produce a tax saving, the taxpayer, as the petitioner concedes,[5] is not given a second chance to deduct so much of the depreciation as was not beneficially deducted the first time; yet the conse-

[5] Cases compelling that concession are: *Beckridge Corp.* v. *Commissioner*, 129 F. 2d 318 (C. C. A. 2d); *Herder* v. *Helver-*

quences of denying him the second chance will be that he will not recover his entire investment tax-free.

This system of depreciation contemplates a consistent pattern of annual deduction, to which the taxpayer is required to adhere. He is not permitted to vary the size of the deduction according to his need for it. An even flow of depreciation is ordinarily contemplated. And it is in accordance with this principle that the taxpayer's basis will be reduced by the correct depreciation "allowable," regardless of whether or not the deductions may have offset income. To hold otherwise, as this Court has pointed out (*United States* v. *Ludey*, 274 U. S. 295, 304) would permit the taxpayer to choose the year in which he will take the deduction; or, stated a bit differently, would permit the taxpayer to reserve some of the depreciation deduction for the years when it would do him the most good.

The petitioner, however, argues for the application of a different rule where it is later found that a portion of the allowance taken was excessive. We think it impossible to reconcile this position with these basic principles. We think there

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ing, 106 F. 2d 153, 162 (App. D. C.), certiorari denied, 308 U. S. 617; *Jones* v. *Commissioner*, 72 F. 2d 114 (C. C. A. 8th); *Kittredge* v. *Commissioner*, 88 F. 2d 632 (C. C. A. 2d). Compare *United States* v. *Ludey*, 274 U. S. 295, and *Hardwick Realty Co.* v. *Commissioner*, 29 F. 2d 498 (C. C. A. 2d), reaching the same result prior to the present statute; Regulations 101, Article 113 (b)-1, *supra*, pp. 4-5.)

is no justification for giving a taxpayer, who has made an excessive claim, this opportunity to vary the even flow of the deductions he has taken and, in effect, make use of them in later years when they will be beneficial, because they had not given him a tax advantage in the years they were taken. We do not think that this opportunity should be given with respect to excessive deductions while being denied with respect to those correctly taken.[6]

Petitioner's position has a further undesirable consequence. Because it defines the word "allowed" as referring only to those deductions which are allowed and applied so as to reduce the tax, the necessary extension of petitioner's position, although petitioner does not argue for it, is that whenever it turns out that a taxpayer has estimated too short a life for his property and has exhausted his basis for depreciation before the property has lost its income producing value, he can compel the Commissioner to restore to his

[6] It should be observed that a taxpayer who takes larger depreciation deductions than those properly allowable derives a tax benefit therefrom in each net income year, in the form of a lower income which not only reduces the tax but reduces it in proportion to his income because it puts his income in lower tax brackets. There is thus a clear monetary incentive to overstate the annual deduction, which incentive is not counteracted under petitioner's view by any risk of wasting the excessive deductions in loss years. Instead petitioner would reserve the loss year excessive deductions for use in some year after the available depreciation would otherwise have been exhausted and when petitioner would otherwise have been paying the piper for having earlier taken excessive deductions.

basis all of the excessive depreciation which he deducted and which did not produce a tax saving, and can then deduct that same depreciation a second time. For example, suppose a taxpayer estimated a 20-year life for a building and the Commissioner did not challenge this estimate; and suppose then that at the end of 20 years the building still had some value and produced some income. It is apparent that too short a life was placed on the building and that as a result more depreciation was deducted each year than the amount which, properly calculated, was "allowable." Therefore, if the basis is reduced by "allowable" depreciation only, the basis will not be reduced to zero notwithstanding that the taxpayer has obtained deductions for amounts equal to 100 percent of the basis. The statute, however, provides that the basis in such circumstances shall be reduced by the amounts for which deduction has been "allowed"; under petitioner's construction a taxpayer could at this time, notwithstanding that he had already fully deducted amounts equal to his total basis, figure back over his returns, determine how much of the deductions had not produced a tax saving, and omit those amounts from the basis reduction. He would then have an unrecovered basis from which to extract a second round of depreciation deductions.

This should be contrasted with the position of the taxpayer who, in a conscientious effort to avoid excessive depreciation deductions, errs the other way and estimates a longer life for his property than it actually has. His annual deductions are consequently smaller than those "allowable," and under the statute the basis must be reduced by all "allowable" depreciation. His basis will thus be reduced to zero before he has deducted amounts equal to the basis of the property, and he will have no means of recapturing those lost deductions for years barred by the statute of limitations. Treasury Regulations 101, Art. 113(b)-1, *supra.*

The favored position which the taxpayer who takes excessive depreciation would have is not only undesirable in itself, but it would also have serious consequences on the administration of the income tax. Many taxpayers, particularly when they believed high incomes were in immediate prospect, would be given added encouragement to overstate their depreciation deductions. For they would not be deterred by the risk that if they should have bad years, they would lose all benefit from the excessive deductions. On the other hand, the incentive given by the Government's position is neither to overstate nor to understate the allowance. Since the Commissioner, at least initially, must rely to large extent on the estimates of life

furnished by the taxpayers themselves, we think it clear not merely that the Government's construction of the Act is administratively sound but that the petitioner's position would add greatly to the burden of fair and efficient enforcement of the statute.

2. Petitioner seeks justification for its position by reading into the content of the word "allowed," as used in the statute, a meaning which it does not possess. For the requirement of a tax benefit cannot be read into the statute if the term "allowed" is given its ordinary connotation in tax practice. In the administration of the federal income tax laws, there is no formal procedure for the allowance of deductions taken upon the returns. Unless the Commissioner takes steps to disallow a claim, it stands "allowed." Presumably Congress used the term with its common meaning—and no more—in mind. If a "tax benefit" test had been intended, it would have been easy to say so by a simple reference to amounts "deducted from gross income." Cf. *Mother Lode Co.* v. *Commissioner,* 317 U. S. 222.

Moreover, it is difficult to understand how "allowed" can have connotations of tax benefit when, as we have stated, it is admitted that "allowable" does not. The differences in meaning and purport between the two words, as used in Section 113 (b) (1) (B) are obvious. "Allowable" covers the amounts to which the taxpayer was legally entitled. "Allowed" covers those permitted or

granted by the Bureau.[7] The argument that "allowed" also means that the deduction must offset income, although "allowable" does not, is consistent neither with the plain meaning of these words nor with the inferences to be drawn from the manner of their use.

The Third Circuit Court of Appeals, in *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. 2d 155, adopted the construction which petitioner urges. The court supported its decision by what it believed were indications in the legislative history of Section 113 (b) (1) (B) that Congress used the word in that section with that meaning. We believe, however, that the court misinterpreted that history.

The first specific provision on this subject was Section 202 (b) of the Revenue Act of 1924, which provided that in computing the adjusted-cost basis deduction should be made for depreciation "previously allowed." The committee reports indicate that the purpose of this provision was simply to

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[7] In I. T. 2944 (XIV-2 Cum. Bull. 126), the terms were defined as follows:

"* * * The word 'allowable' designates the amount permitted or granted by the statutes, as distinguished from the word 'allowed' which refers to the deduction actually permitted or granted by the Bureau. The amount 'allowable' is the minimum for adjustment purposes, the amount 'allowed' serving to measure the adjustment only when the amount thereof exceeds that allowable.

"It follows that the depreciation claimed as a deduction in a return which has been accepted by the Bureau is the amount 'allowed' for that year. * * *"

confirm Treasury practice, as subsequently approved in *United States* v. *Ludey* and *Hardwick Realty Co.* v. *Commissioner, supra,* note 6, and nothing was suggested of any tax-benefit limitation. H. Rep. No. 179, 68th Cong., 1st Sess., pp. 12–13 (1939–1 Cum. Bull. (Part 2) 241, 250); S. Rep. No. 398, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 266, 275); H. Conference Rep. No. 844, 68th Cong., 1st Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 300). Section 202 (b) of the Revenue Act of 1926 dropped the expression "previously allowed" and used in its place depreciation "allowable." So far as appears, this change was effected, not because of any purpose to relieve the taxpayer from the amount of depreciation claimed by him in his return where no tax benefit resulted, but because certain taxpayers contended that under the 1924 Act they were not obliged to take depreciation on a yearly basis and could if they chose use the initial cost basis in determining gain or loss from the sale of the property in a later year, S. Rep. No. 52, 69th Cong., 1st Sess., p. 16 (1939–1 Cum. Bull. (Part 2) 332, 344).[8] This provision is also contained in Section 111 (b) (2) of the Revenue Act of 1928.

[8] The report stated in part:

"Under existing law in the case of determining gain from the sale or other disposition of property, the cost or March 1, 1913, value of such property is required to be reduced by the amount of depreciation or depletion allowed under prior income tax laws. It has been claimed that the effect of this provision is to allow a taxpayer to elect to take no deprecia-

In Section 113 (b) (1) (B) of the Revenue Act of 1932 the law was again changed so as to provide for adjustment for depreciation "to the extent allowed (but not less than the amount allowable)" under that Act or prior laws. It is this same provision which is contained in the Revenue Act of 1938, involved in the instant case. The occasion for the change in 1932, as stated in the Senate Report, was to prevent a taxpayer who had claimed deduction at a given rate for a period of years from contending in a later year that the earlier rate was excessive and that the amounts which were in fact "allowable" were much less.[9] The report pointed out that in the later year the Government might be barred from collecting the additional taxes due for the earlier years from the application of the amount of deduction later claimed to be "allowable." The report did not concede that the then existing law permitted this result but expressed the belief that "a new bill

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tion or depletion against his annual income and to permit him to write off the entire cost or March 1 value at time of sale. The bill as passed by the House provides that the cost or March 1, 1913, value in the case of sale shall be reduced by the amount of depreciation or depletion allowable under prior income tax Acts in computing the gain subject to tax. It is believed that the rule stated by the House bill is the correct rule and that all taxpayers should be required to take proper annual deductions for depreciation and depletion."

[9] Should petitioner prevail herein, a consequence will be, as noted *supra*, pp. 16–17, that the 1932 amendment must be interpreted to compel, insofar as the excessive deductions resulted in no tax benefit, the very result which it was designed to prevent.

should specifically preclude any such possibility." [10] And while the illustration given by the Senate Committee was that of a taxpayer who had achieved a tax benefit from the amount of depreciation "allowed" in earlier years, there is noth-

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[10] The Senate Report provided in full as follows (S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 496, 517):

"In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made 'to the extent allowed (but not less than the amount allowable)' instead of 'by the amount * * * allowable' as in the prior Act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility. Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayers in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made."

ing in the report which indicates an understanding that the amount of depreciation "allowed" was restricted to that part of the claimed depreciation from which a tax benefit accrued. Rather, in view of the manner in which Congress had previously used the terms "allowed" and "allowable" interchangeably, and in view of the fact that the term "allowable" was not limited by any theory of tax benefit, the inference is that Congress likewise used the word "allowed" in the same unrestricted sense.

It is thus evident, we submit, that in the *Pittsburgh Brewing* case the Third Circuit Court of Appeals misinterpreted the legislative history of Section 113 (b) (1) (B) and read a meaning into the amendment which actually has the effect of causing a result which the amendment was designed to prevent.[11] It is significant that although a majority of the Board of Tax Appeals bowed to that decision in *Kennedy Laundry Co.* v. *Commissioner*, 46 B. T. A. 70,[12] the only two circuit courts of appeals to consider the problem subsequently have expressly disagreed with the Third Circuit Court of Appeals.[13] Moreover, in *Beckridge*

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[11] See *supra*, note 9, p. 22.

[12] As have two District Courts: *Don Lee, Inc.* v. *United States*, 42 F. Supp. 884 (N. D. Cal.); *Gunnison Sugar Co.* v. *Hinckley*, 1942 C. C. H. § 9812. These cases are pending on appeals to the Ninth and Tenth Circuit Courts of Appeals respectively.

[13] The Fourth Circuit Court of Appeals in the instant case, and the Seventh Circuit Court of Appeals in *Commissioner*

Corp. v. *Commissioner,* 129 F. 2d 318, the Second Circuit Court of Appeals expressed its disapproval of the *Pittsburgh Brewing* decision.

A further error in the *Pittsburgh Brewing* decision is its easy assumption that the excessive depreciation deduction did not serve to offset gross income and reduce the tax because the taxpayer had a net loss equal to or greater than the excessive depreciation deduction. This assumption overlooks the existence of a serious problem and is probably erroneous.[14] While the taxpayer

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v. *Kennedy Laundry Co.*, 133 F. 2d 660. The decision was criticized also in a note in 40 Columbia L. Rev. 540.

[14] It was vigorously challenged by Judge Disney in his dissent in *Kennedy Laundry Co.* v. *Commissioner*, 46 B. T. A. 70, 75 (reversed in 133 F. 2d 660 (C. C. A. 7th)). He said: "* * * The majority opinion in substance is that the net loss was caused by one item, to wit, depreciation of $22,387.60, out of the possibly many deducted items totaling $284,265.33, that is, that such item was the particular one which put the petitioner's account 'in the red.' Omitting the depreciation item, and subtracting $22,387.60 from $284,265.33, leaves $261,877.73 of deductions, and, compared with gross income of $279,043.96, such total of deductions left the petitioner, not with a net loss, but with a net profit of $17,166.23. The majority opinion amounts to saying that such profit was wiped out and converted into a net loss of $5,221.37 by the item of depreciation. I can conceive no reason for saying that it was that particular item of depreciation which caused the net loss. Depreciation is in the same category with all other deductible items. It is based upon wear and tear upon properties, which wear and tear contributes as much to the production of the gross income as does current expense, for example. I therefore discern no reason to distinguish between the deductible items making up the total of $284,265.33 and to say that any one of them caused the net loss. Plainly no single item caused the total.

would not have had net income even in the absence of the excessive depreciation deduction because it had other deductions sufficient in amount to offset all its gross income, this is equally true of each other deduction in equal extent. Therefore it is a *tour de force* to ascribe the failure to offset income solely to the depreciation deduction, when the plain fact is that no one deduction produced the final result but all of them together did. As they all shared in reducing income to a negative figure, each must be given credit for doing so proportionately with its fellows, and consequently the excessive depreciation deduction did so only in the proportion which it bears to all the other deductions. It follows, therefore, that some part of the depreciation deduction did produce a tax saving and some did not. This analysis is supported by the decision in *Butler Bros.* v. *McColgan,* 315 U. S. 501, 508–509, where, in considering a comparable problem arising out of the allocation of income between states for state tax purposes, this Court refused to countenance the singling out of one item as solely chargeable with producing a negative result where several items

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Though it well may be that depreciation should logically be considered as contributing to the net loss, I can see no rational principle under which to consider it so to do except ratably in the proportion that $22,387.60 bears to $284,-265.33. In other words, the net loss is seen to be caused by depreciation, only to the extent of the fraction of 22,387.-60/284,265.33 of $5,221.37. * * *"

necessarily contributed to it. We submit, therefore, that in the absence of a legislative declaration that some particular deduction shall be singled out and credited with not offsetting gross income and thus not producing a tax saving, a court may not, as the Third Circuit Court of Appeals did, charge a single deduction to the exclusion of all others with not effecting a tax benefit.[15]

4. Finally, the recent amendment to the revenue laws enacted in Section 116 of the Revenue Act of 1942 bears against petitioner. That section provides that upon the recovery of bad debts, prior taxes, or "delinquency amounts," that portion of the prior allowance which did not result in a tax reduction shall be excluded from gross income. Public Law 753, 77th Cong., 2d Sess.[16]

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[15] The Board in the case at bar also ascribed the entire failure to produce a tax saving solely to the excessive depreciation deduction, but the Commissioner cannot complain of the Board's action in this case because he stipulated that the excessive depreciation deductions did not offset taxable income (R. 25). The point is raised in other cases, however, and is relevant herein because it shows how thoroughly the Third Circuit Court erred. Its elaboration is also necessary to the point hereafter discussed in the text.

[16] SEC. 116. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

(a) *Exclusion From Income.*—Section 22 (b) (relating to exclusions from gross income) is amended by adding at the end thereof the following new paragraph:

The amendment deals with a problem analogous to that presented in the instant case. Prior to its adoption, the Third and Fourth Circuit Courts of Appeals had both held that such recoveries constituted income whether or not the prior deductions had resulted in a tax benefit. *Commissioner* v. *United States & Int. Sec. Corp.*, 130 F. 2d 894 (C. C. A. 3d); *Helvering* v. *State-Planters Bank & Trust Co.*, 130 F. 2d 44 (C. C. A. 4th). Moreover, in the *State-Planters* case, the court considered and rejected the argument that, in the

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"(12) *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

"(A) *Definition of Bad Debt.*—The term 'bad debt' means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

"(B) *Definition of Prior Tax.*—The term 'prior tax' means a tax on account of which a deduction or credit was allowed for a prior taxable year.

"(C) *Definition of Delinquency Amount.*—The term 'delinquency amount' means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

"(D) *Definition of Recovery Exclusion.*—The term 'recovery exclusion,' with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner

absence of a tax benefit, the prior deductions had not been "allowed" within the meaning of the applicable regulations (Regulations 103, Sec. 19.23 (k)-1), and it relied on that decision in the instant case.

The statutory change is significant in two principal respects: *First,* the statute itself and the accompanying committee reports provide clear evidence that Congress does not regard the tax benefit theory as any part of the revenue laws in the absence of specific provision to that effect. *Secondly,* the judicial adoption of such a rule in the present situation would result in serious conflict between the application of that statute and such a judicial rule.

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with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph."

* * * * * * *

(b) *Effective Date of Amendments Under the Internal Revenue Code.*—The amendments made by this section shall be applicable with respect to taxable years beginning after December 31, 1938.

(c) *Under Prior Revenue Acts.*—For the purposes of the Revenue Act of 1938 or any prior revenue Act, the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such revenue Act on the date of its enactment.

The new regulations have not yet been issued.

It is evident from a reading of the statute that it is framed on the theory that a deduction is "allowed" whether or not it has resulted in a tax reduction. The statute (clauses (A) and (B)) speaks specifically of deductions for bad debts and prior taxes "allowed" in a prior taxable year, although by hypothesis there was no tax benefit. Thus it uses the word "allowed" as we urge it should be used herein. Furthermore, the amendments assume that the recoveries would otherwise constitute taxable income. This is directly stated in the accompanying committee reports (S. Rep. 1631, 77th Cong., 2nd Sess., p. 79; H. Rep. 2333, 77th Cong., 2nd Sess., p. 69) and appears from the face of the statute. It is evident that Congress regarded the rule it was overturning as inexpedient rather than erroneous under previous law, and that in adopting the amendment Congress did not intend to reflect an over-all legislative policy to write a "tax benefit" test into the revenue laws generally. This conclusion is fortified by the fact that the amendment applies only in three carefully defined situations although obviously the question could arise in others.[17] The only reasonable inference to be drawn from the amendments is that Congress intended to change the law in those particulars and in no others.

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[17] Compare the instant situation, and those presented in *Harwick* v. *Commissioner*, 133 F. 2d 732 (C. C. A. 8th), certiorari applied for, No. 933, present term, and *Douglas* v. *Commissioner* (C. C. A. 8th), decided April 7, 1943.

The provisions of Section 116 (a) not only amended the Code but also, for the purposes of the Revenue Act of 1938 and prior revenue acts, were expressly made "effective as if they were a part of each such revenue Act on the date of its enactment." Section 116 (c), *supra*, note 16. The amendments, therefore, are part of the statute now under consideration by the court. It is a well-settled rule of statutory construction that where Congress has specifically dealt with a question in one section of a statute, that section will be regarded as exclusive. It will not be presumed that the matter was also regarded as covered in another section of general import. (Cf. *Baltimore Nat. Bank* v. *Tax Commission*, 297 U. S. 209, 215.)

With the question whether, as a matter of legislative tax policy, the "tax benefit" rule should be extended to this situation, we are not here concerned. So far, Congress has not extended it, and whether or not it ever will no one can say. The question basically is but another aspect of the broader problem of "lost" deductions, ordinarily in the forefront in connection with the adoption of provisions for loss carry-overs.

Adoption of petitioner's position herein would create a serious problem of conflict with the 1942 amendment, because in enacting that amendment Congress indicated that it wished the bad debt, tax, and "delinquency amount" deductions to be deemed to have been last deducted, so that they

will be deemed to have been of no tax benefit if the taxpayer could have refrained from deducting them without affecting his tax due for the year of deduction.[18] As we have pointed out,[19] in the absence of a legislative declaration no such rule can properly be adopted. If, therefore, the tax benefit rule be judicially applied to excessive depreciation deductions, how will the computation of the proportional benefit be made in the case of a taxpayer who has, for example, both a bad debt recovery to eliminate and a depreciation basis adjustment to make because of the tax benefit rule? And if the proportional benefit rule is not applied to excessive depreciation deductions, which deduction shall be deemed to have been taken last and hence to have been the source of no tax benefit, the bad debt, as to which Congress has specifically legislated, or the depreciation deduction, as to which it has not? We believe that had Congress been of the view that the tax benefit rule applied to excessive depreciation deductions, it would have given us the answer to these problems, for it could not have been blind to their existence. Its failure to do so is, we submit, further evidence that Congress was of the view that the tax-benefit rule is not applicable to excessive depreciation deductions.

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[18] Senate Report 1631, 77th Cong., 2nd Sess., p. 80.

[19] *Supra*, pp. 25–27.

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted.

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